Centre-State Financial Relations: A Study on the Role of Finance Commission

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ABSTRACT

A federal economy is usually characterised by the emergence of imbalances between functional responsibilities and financial resources of different tiers of government. Vertical imbalances in terms of resources and expenditure responsibilities emerge between different levels of government calling for transfer of resources from the Centre to the States. Thus, intergovernmental transfers are an inherent part of a multi-level fiscal system. In India, Finance Commission constitutes an important channel of Central transfers to the states. This paper looks at the role of Finance Commission regarding the devolution of taxes between the Center and the States from the divisible pool. In particular, the paper focuses on the Fourteenth Finance Commission FFC that has made far-reaching changes in tax devolution that will move the country towards greater cooperative as well as competitive federalism.

Keywords: *Finance Commission; Centre-state financial relations; Horizontal devolution; Vertical devolution.*

1.0 Introduction

The Constitutional provisions regarding taxation and borrowing powers of the Centre and the States, place the former in a commanding position. Not only the major sources of tax revenue belong to the Centre, its borrowing (internal and external) powers are also unlimited. Moreover, the Central Government enjoys the exclusive right to print currency. Though the Constitution creates a dual polity based on divided governmental powers and functions, this division is not watertight. As the Administrative Reforms Commission, 1968, observed, "Exact correspondence of resources and functions is not possible to secure in any federal situation but in India the balance is tilted rather heavily in favour of the Centre and the outstanding feature of the financial relationship between the Centre and the States consequently is that the former is always the giver and the latter the receivers.

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The favourable position given to the Centre in regard to financial resources reflects the strong-centre theme running through the Constitution and many feel that this has been an important factor in keeping the country united." (Administrative Reforms Commission, 1968, p.15) Emergence of imbalances between functional responsibilities and financial resources of different tiers of government is a characteristic feature of all federations, particularly of those whose economies are more dynamic. Even in older federations (like the United States, and Canada), financial conflicts between the national and sub-national governments persist and their once-for-all solution is difficult to find. The mismatch between functions and taxation powers occurs partly because of changing responsibilities of governments at different levels and partly because of the dominant position of federal government in regard to taxation powers, which is often by design. Therefore, vertical imbalances in terms of resources and expenditure responsibilities emerge between different levels of government calling for transfer of resources from the Centre to the States. This is the familiar problem of federal finance. Thus, intergovernmental transfers are an inherent part of a multi-level fiscal system. Such transfers are justified on horizontal equity considerations.

2.0 Mechanism of Central Transfers to the States

Recognising the fact that the financial resources of the States may prove inadequate for undertaking welfare, maintenance, and development activities, the framers of India's Constitution did make elaborate, *albeit* complex, arrangements relating to flow of funds from the Centre to the States. The disequilibrium between proliferating functional responsibilities of the States and their own resources is corrected by Central transfers effected through three main channels.

(i) Statutory transfers through the Finance Commission.
(ii) Plan transfers through the Planning Commission (now abolished).
(iii) Discretionary transfers for Centrally Sponsored Schemes, relief from natural calamities, and relief and rehabilitation of displaced persons.

Apart from these direct transfers, resources also flow to the States indirectly through the following channels.

(i) Establishment/expansion of Central public sector enterprises.
(ii) Subsidised lending by banking and financial institutions.
(iii) Subsidised borrowing by the States from the Central Government and the banking system.

These may be called invisible transfers or subterranean transfers.

2.1 Transfer of resources through the Finance Commission

The Finance Commission is a Constitutional body formulated under Article 280 of the Indian Constitution. It is constituted every five years by the President of India to review the state of finances of the Union and the States and suggest measures for maintaining a stable and sustainable fiscal environment. It also makes recommendations regarding the devolution of taxes between the Center and the States from the divisible pool which includes all Central taxes (excluding surcharges and cesses) which the Centre is constitutionally mandated to share with the states.

Transfers routed through the Finance Commission pertain to sharing of certain Central taxes, and grants-in-aid of revenues of the States. In other words, although the taxation powers allocated to the Centre and the States are mutually exclusive yet all the taxes and duties levied by the Centre are not meant entirely for the Centre. In fact, revenues from certain taxes and duties leviable by the Centre are totally assigned to or shared with the States to supplement the revenues of the States in accordance with their needs.

The architects of the Constitution probably realised that even with a share in the proceeds of divisible taxes, some States might still need financial assistance. Accordingly, they made provision for annual grants-in-aid of revenues under Article 275(1) to such States as may be in need of assistance. Also, the Centre is required to give grants-in-aid to the States for the welfare of Scheduled Tribes and for raising the level of administration in Scheduled Areas and separately for Assam. These provisions which set apart a portion of Central revenues for the benefit of States indicate flexibility of India's Constitution in terms of distribution of financial resources between the Centre and the States.

2.1.1 Finance Commission

Although the Constitution provides for Central transfers, it neither indicates the share of the States in the divisible taxes nor prescribes any principles for the distribution of States' share among the States themselves. Framers of the Constitution consciously avoided permanent formulae in this regard in view of expected changes in the spheres of taxation and public expenditure. Thus, the precise manner of sharing taxes and the actual determination of grants is left to the deliberations of the Finance Commission which is appointed by the President (under Article 280) every quinquennium, or earlier if necessary[1]. The Finance Commission, consisting of a chairman and four members, recommends to the President, *inter alia*, the principles of distribution between the Union and the States of the proceeds of taxes and the allocation among the States of the shares of such proceeds. The recommendations of Finance Commissions are based on a detailed assessment of the financial position of the Central and State Governments. For this purpose, the Commissions visit the State Capitals and hold discussions with government leaders and officials. Discussions are also held with public finance experts and studies are commissioned on specific topics.

2.1.2 Powers and procedures

Under sub-clause (2) and (4) of Article 280 of the Constitution, the qualifications which shall be requisite for appointment as Members of the Commission and the manner in which they shall be selected have to be determined by Parliament by law and the Commission shall have such powers in the performance of their functions as Parliament may by law confer on them.

The Constitution authorises the Commission to determine their procedure, while the Finance Commission (Miscellaneous Provisions) Act, 1951, has conferred on the Commission all the powers of a Civil Court under the Code of Civil Procedure, 1908. The Commission have also been empowered to require any person to furnish information on such points or matters as, in the opinion of the Commission, may be useful for, or relevant to, any matter under the consideration of the Commission. The powers conferred on the Commission are set out in detail in Section 8 of the Act mentioned earlier.

As the Sixth Finance Commission remarked, “The purpose of Finance Commission, as envisaged in the Constitution, is primarily to facilitate a periodical assessment of the fiscal needs of the States and the formulation on an objective basis of proposals for transfer of resources from the Centre to the States through devolution of taxes and grants-in-aid. But an incidental and by no means insignificant advantage of the appointment of a Finance Commission has generally been to rekindle interest in issues pertaining to financial relations between the Centre and the States and to promote an enlightened national debate on the several facets of our federal fiscal set up.” (Ministry of Finance, 1973, p. 5).

Under Article 281 of the Constitution, the report of the Finance Commission, together with the Explanatory Memorandum on the action taken on the recommendations of the Commission, is laid on the Table of the House by the Government. Though the President is not bound to accept the recommendations of the Finance Commission, they are generally accepted in view of the quasi-judicial nature of the Commission[2]. By and large, the Finance Commissions have worked independently and some of them, particularly the recent ones, have been quite assertive. Award of a Finance Commission generates considerable interest in issues pertaining to financial relations between the Centre and the States. Thirteen Finance Commissions have reported since the commencement of the Constitution. The work of the Fourteenth Finance Commission is under way. The years of establishment, years of reporting, periods of award, and the names of Chairmen of various Finance Commissions are given in Table 1.

Table 1: Chronology of Finance Commissions in India

Finance Commission	Year and month of establishment	Year and month of reporting	Period of award	Name of the Chairman
First	November 1951	December 1952	1952-53 to 1956-57	K.C. Neogy
Second	June 1956	September 1957	1957-58 to 1961-62	K. Santhanam
Third	December 1960	December 1961	1962-63 to 1965-66	A.K. Chanda
Fourth	May 1964	August 1965	1966-67 to 1968-69	P.V. Rajamannar
Fifth	February 1968	July 1969	1969-70 to 1973-74	Mahavir Tyagi
Sixth	June 1972	October 1973	1974-75 to 1978-79	K. Brahmananda Reddy
Seventh	June 1977	October 1978	1979-80 to 1983-84	J.M. Shelat
Eighth	June 1982	April 1984	1984-85 to 1988-89	Y.B. Chavan
Ninth	June 1987	July 1988* and December 1989#	1989-90* and 1990-91 to 1994-95#	N.K. P. Salve
Tenth	June 1992	November 1994	1995-96 to 1999-00	K.C. Pant
Eleventh	July 1998	July 2000	2000-01 to 2004-05	A.M. Khusro
Twelfth	November 2002	November 2004	2005-06 to 2009-10	C. Rangarajan
Thirteenth	November 2007	December 2009	2010-11 to 2014-15	Vijay Kelkar
Fourteenth	January, 2013	December 2014	2015-16 to 2019-20	Y.V. Reddy

*First Report; #Second Report

Source: Finance Commission Reports.

Finance Commission is a unique feature of the Indian Constitution having no parallel in the existing federal constitutions of the world. As the Commission on Centre-

State Relations, 1988 observed, “Unlike the Commonwealth Grants Commission of Australia, the Indian Finance Commission is a Constitutional body and the objectivity in its role has been facilitated by keeping it outside the Union executive. Compared with its Australian counterpart, the Indian Finance Commission has a greater scope inasmuch as it recommends sharing of tax proceeds also, besides the grants-in-aid, and advises on other matters referred to it in the interest of sound finance. The absence of clear Constitutional provisions for revenue sharing created many problems in other federations and they had to evolve a variety of arrangements to overcome them. For example, in Canada, tax-rental arrangements were resorted to. In Australia, the Australian Commonwealth Grants Commission was set up to consider allocation of grants among the claimant States. Specific purpose grants, with strict enforcement conditions, came into existence in countries like USA.” (Government of India, 1988, p. 254)

The Australian Commonwealth Grants Commission recommends special purpose grants to the claimant States, but the general grants are determined largely on the basis of negotiations at the political level. In India, the Finance Commission has replaced political bargaining by objective criteria in regard to devolution of resources, ensuring at the same time flexibility in revenue-sharing.

What is a Finance Commission expected to achieve? Its first task is to evolve a scheme of transfer of financial resources from the Centre to the States so as to ensure financial equilibrium at the two levels of Government during the period of its award. Secondly, it is to design formulae to allocate resources so transferred among the States.

The task of the Finance Commission consists of the following.

(i) Forecasting resources and expenditure of the Central Government to determine the volume of resources to be transferred to the States during the ensuing five years.

(ii) Forecasting own current revenues of the States and non-Plan current expenditures.

(iii) Devising formula for distribution of States’ share among the States themselves.

(iv) Filling the post-devolution projected gaps with grants between the non-Plan current expenditures and current revenues.

The task of a Finance Commission is by no means easy as it has to judge the conflicting claims, needs, and resources of the Centre and the States and evolve a scheme of transfers which would balance the needs and resources of the two layers of the Government. Broadly speaking, the procedure adopted by the Finance Commission to fulfil its duties is as follows: On the basis of the trends in the finances of Central and State Governments, it prepares estimates of revenue and expenditure for the period of its award. It then decides the total amount of transfers from the Centre to the States so as to maintain the desired equilibrium in the finances of the two tiers of the Government.

Thereafter, the total amount of transfers is broken down into devolution and grants-in-aid among the States. Transfer of resources from the Centre to the States is designed to correct vertical imbalances while the distribution of resources among the States (with wide differentials in fiscal capabilities and needs) aims at correcting horizontal imbalances.

Should Central transfers to the States through the Finance Commission be examined in their totality or item-wise? For a better understanding of the nature and role of these transfers, it is necessary to examine them from both angles. The total approach is significant to understand adjustments in vertical financial imbalances while item-wise approach reveals adjustments in horizontal financial imbalances. It is noteworthy that various items included in the aggregate transfers are not alike and therefore have different importance for different States.

Commenting upon the working of the Indian federal polity, the Sixth Finance Commission observed, "Among the various federal polities in the world today, the Indian federal fiscal system whether one views it as federal or quasi-federal, is undoubtedly among the few that have demonstrated remarkable resilience in coping satisfactorily with the new demands made on it from time to time. The provisions of the Constitution concerning financial relations between the Centre and the States seem to have been designed with great care and circumspection so as to forestall precisely the kind of difficulties that even the older federations do not appear to have overcome in securing closer correspondence between resources and functions of the different layers of Government. These observations should not be construed as implying that the present matrix of financial relations between the Centre and the States does not admit of improvement or simplifications. All that we would like to stress is that the financial provisions of our Constitution give enough room for reconciling such conflicts of interest as may arise from time to time between the Union and the constituent units. If despite these well-conceived provisions of the Constitution, some signs of dissatisfaction are discernible in the actual conduct of financial affairs between the Centre and the States, the reasons are to be found partly in the stresses and strains which the national economy as a whole has had to face in recent years and also perhaps in the spirit in which the provisions of the Constitution have sometimes been worked." (Ministry of Finance, 1973, p.5)

2.2 From Itemised Sharing to Global Sharing

The most important development in the field of Centre-State financial relations pertains to the new system of sharing Central taxes with the State Governments. Prior to Constitution (Eightieth Amendment) Act, 2000, income tax and Union excise duties were the only taxes shared with the States, apart from the grants given in lieu of passenger tax, and the collections from additional excise duty in lieu of sales tax sugar, tobacco and textiles. Taxes on income and Union excise duties were shared with States under Article 270 and 272 respectively. The aforesaid amendment altered the pattern of sharing of Central taxes between the Centre and the States significantly. It substituted a new Article for Article 270 and omitted the old Article 272. The new Article 270 provides for the sharing of the net proceeds of all Union taxes and duties with the States. However, the surcharge levied for purposes of the Union under Article 271 is excluded from the divisible pool. Eleventh Finance Commission was the first to make recommendations in accordance with the new provisions of the Constitution.

2.2.1 Fourteenth Finance Commission (FFC)

The Fourteenth Finance Commission (FFC) was appointed on January 2, 2013 under the chairmanship of Y.V. Reddy, former Governor of Reserve Bank of India (RBI). Other members of the commission included Abhijit Sen, Sushma Nath, M. Govinda Rao and Sudipto Mundle. In addition to the primary objectives mentioned above, the terms of reference for the commission sought suggestions regarding the principles which would govern the quantum and distribution of grants-in-aid (non-plan grants to states), the measures, if needed, to augment State government finances to supplement the resources of local government and to review the state of the finances, deficit and debt conditions at different levels of government.

Main Recommendations of FFC

FFC submitted its recommendations for the period 2015-16 to 2019-20. They are likely to have major implications for Center-State relations, for budgeting by, and the fiscal situation of, the Centre and the States. Some of the major recommendations of FFC are as follows:

- FFC radically enhanced the share of the states in the central divisible pool from the existing 32 percent to 42 percent which was the biggest ever increase in vertical tax devolution. The previous two Finance Commissions, viz. Twelfth Finance Commission (period 2005-06 to 2009-10) and Thirteenth Finance Commission (period 2010-11 to 2014-15) had recommended a share for states share of 30.5 percent (increase of 1 percent) and 32 percent (increase of 1.5 percent), respectively in the central divisible pool.
- FFC formulated a new horizontal formula (Table 2) for the distribution of the states' share in divisible pool among the states. There are changes both in the variables included/excluded as well as the weights assigned to them. Relative to the Thirteenth

Finance Commission, FFC incorporated two new variables: 2011 population and forest cover; and excluded the fiscal discipline variable.

- Several other types of transfers were proposed including grants to rural and urban local bodies, a performance grant along with grants for disaster relief and revenue deficit. These transfers totaled to approximately Rs. 5.3 lakh crore for the period 2015-16 to 2019-20.
- FFC did not make any recommendation concerning sector specific-grants unlike the Thirteenth Finance Commission.

Table 2: Horizontal Devolution Formulas of the Thirteenth and Fourteenth Finance Commissions

Variable	**Weights accorded**	
	Thirteenth Finance Commission	**Fourteenth Finance Commission**
Population (1971)	25	17.5
Population (2011)	0	10
Fiscal capacity/income distance	47.5	50
Area	10	15
Forest cover	0	7.5
Fiscal discipline	17.5	0
Total	100	100

Sources: Thirteenth and Fourteenth Finance Commissions

All states stand to gain from FFC transfers in absolute terms. The biggest gainers in absolute terms under General Category States were Uttar Pradesh, West Bengal and Madhya Pradesh while for Special Category States they were Jammu & Kashmir, Himachal Pradesh and Assam. A better measure of impact is benefit per capita. The major gainers in per capita terms were Kerala, Chhattisgarh and Madhya Pradesh for GCS and Arunachal Pradesh, Mizoram and Sikkim for SCS.

FFC recommendations are expected to add substantial spending capacity to budgets of states. FFC transfers have more favorable impact on the states (only among the GCS) which are relatively less developed which is an indication that the FFC transfers are progressive**,** i.e. states with lower per capita net state domestic product (NSDP) receive on average much larger transfers per capita. This indicates that the FFC recommendations do go in the direction of equalizing the income and fiscal disparities between the major states.

A final interesting finding relates to the decomposition of the resource transfers through tax devolution due to the increase in the divisible pool per se and due to the change in the horizontal devolution formula itself. The significant impact due to increase in the divisible pool is on states like Uttar Pradesh, Bihar, Madhya Pradesh, West Bengal and Andhra Pradesh (United) while states like Arunachal Pradesh, Chhattisgarh, Madhya Pradesh, Karnataka and Jharkhand are the major gainers due to a change in the horizontal devolution formula which now gives greater weight to a state's forest cover.

3.0 Conclusion

Finance Commission constitutes an important mechanism of Central transfers to the States. The spirit behind the FFC recommendations is to increase the automatic transfers to the states to give them more fiscal autonomy and this is ensured by increasing the share of states from 32 to 42 percent of divisible pool. However, there is concern that fiscal space or fiscal consolidation path of the Centre would be adversely affected. To ensure that the Centre's fiscal space is secured, the suggestion is that there will be commensurate reductions in the Central Assistance to States (CAS) known as *plan transfers.* FFC has made far-reaching changes in tax devolution that will move the country toward greater fiscal federalism, conferring more fiscal autonomy on the states. This will be enhanced by the FFC-induced imperative of having to reduce the scale of other central transfers to the states. In other words, states will now have greater autonomy on the revenue and expenditure fronts. In sum, the far-reaching recommendations of the FFC will further the Government's vision of cooperative and competitive federalism.

Endnotes

1. Since the President is guided in all his decisions by the advice of the Central Council of Ministers (Article 74), the appointment of the Finance Commission and the determination of its terms of reference becomes the prerogative of the Central Government for all practical purposes. This prerogative of the Centre is often criticised because the Centre itself is a party to the *dispute* between the Centre and the States regarding sharing of financial resources, and the role of the Finance Commission is that of an arbiter.
2. Article 280(3) requires the Finance Commission to make recommendations to the President who is to lay the same under Article 281 before each House of Parliament. It is nowhere laid down in the Constitution that recommendations of the Commission shall be binding upon the Government of India. They are, therefore, non-justiciable. However, to safeguard the interests of the States in the Union taxes which are divisible, the Constitution provides

(Article 274) that no bill or amendment which (i) varies the rate of tax in which the States are interested; (ii) affects the principles on which moneys are distributable or (iii) imposes any surcharge on any such tax for the purpose of the Union, shall be introduced or moved in the Parliament except on the recommendation of the President. The Centre has generally accepted the major recommendations of the Finance Commissions though there are some instances of partial acceptance of such recommendations. For example, the Centre did not accept the entire set of recommendations of the Eighth Finance Commission relating to the first year (1984-85) of the five year period covered by it. The Centre held the view that by the time the report was submitted (April 30, 1984), the Central and the State budgets had been passed and it was late to reopen the estimates. However, it was widely felt that this decision of the Government was in violation of the spirit of Article 280 of the Constitution.

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